

According to the information submitted, Association was established pursuant to Section 1 of State Statute and is a residual risk pool for State's property insurance market to provide B insurance in certain designated portions ("Catastrophe Area") of State. Section 1 provides that Association's purpose is the provision of an adequate market for B insurance in Catastrophe Area of State. The legislature finds that the provision of adequate B insurance is necessary for the economic welfare of the State, and that without that orderly growth and development of this State would be severely impeded.

The Association is intended to serve as the residual insurer of last resort for B insurance in Catastrophe Area of State. Association shall function in such a manner as to not be a direct competitor in the private market; and to provide B insurance to those unable to obtain that coverage in the private market. Thus, Association was created to address a crisis in the availability of insurance in the voluntary market as a result of rising policy losses associated with catastrophic events such as A in Catastrophe Area of State.

All insurance companies that write property insurance in State must be members of Association. Catastrophe-type insurance not voluntarily written by member insurers is provided by policies issued by Association. Association is also authorized to (1) cause issuance of insurance policies for applicants, (2) assume reinsurance from members, (3) cede reinsurance to members, and (4) purchase reinsurance on behalf of its members. Association is required to provide coverage to any person having an insurable interest in insurable property in Catastrophe Area designated by Department who (or which) after making diligent efforts, is unable to obtain insurance in the voluntary market. Association is not authorized to write policies outside Catastrophe Area. If Association determines a Catastrophe Area should no longer be so designated by Commissioner, Association may request the Commissioner to remove such area from such designation. Commissioner makes the final determination as to whether an area is designated as a Catastrophe Area (upon 10 days notice and hearing) or to remove such designation.

Association is governed by a C member Board of Directors (the Board). Prior to Date 1, a majority of the Directors were elected from all insurance companies that wrote property insurance in State. Effective Date 1, all Directors are appointed by Commissioner, and Directors elected from insurance companies are no longer a majority of the Board. D Directors are appointed from a slate of candidates nominated by insurance companies. The slate must include at least three more nominees than the number of vacancies. There are requirements for members of the board including that D must reside in coastal counties, one must be from an area of state that is not located in seacoast territory. All board members must have demonstrated expertise in insurance, general business or actuarial principles. Commissioner is required to appoint one person to serve as nonvoting member to advise the Board relating to the inspection process. Members of the Board serve staggered three-year terms and no person may hold a seat for more than three consecutive full terms, not to exceed nine

years. A member of the Board may be removed for cause by the Commissioner with cause stated in writing, and the Commissioner shall appoint a replacement.

Procedures for setting Association's rates are provided in the Code. Association proposes to the Department the rates for the policies and the terms of the coverage (as part of a required filing with the Department). This is subject to review and approval of the Commissioner who will, in writing, approve or disapprove the filing. Association's filing is considered approved unless disapproved on, or before, the 30th day after the date of filing. If the Commissioner disapproves a filing, the Commissioner shall state in writing the reasons for disapproval and the criteria Association is required to meet to obtain approval. Code also provides situations where Association may use a rate filed by it without prior Commissioner approval where the rate is filed within a certain time frame, the rate is within a range of existing rates and the Commissioner has not disapproved the rate.

The Statute provides for the use by Association of its net gains from operations for a variety of purposes related to its designated function. Net gain is the excess of premiums and other revenues of Association in excess of incurred losses and operating expenses. Net gain is used to make annual payments to Fund, and to procure reinsurance.

The Fund's purpose is to fund excess losses of Association and a portion of its investment income may be used to fund a state mitigation and preparedness plan that provides for steps to be taken in Catastrophe Area by the Commissioner, state or local governments, state agencies, education institutions or nonprofit organizations designated by the Commissioner to implement programs to improve preparedness for B catastrophes, reduce potential losses in the event of such a catastrophe, provide research into the means to reduce such losses, educate or inform the public in determining the appropriateness of particular structural upgrades or protect infrastructure from potential damage during those catastrophes. All of the Fund's money is considered state money held by the State Treasurer outside the State Treasury on behalf of, in trust for, and with legal title in the Department. Upon Fund's termination, all of its assets revert to the State Treasury to provide funding for the mitigation and preparedness plan.

None of Association's assets may inure for the benefit of any private shareholder or individual. The assets may only be used for specified purposes including a) satisfying a claim made on a policy of Association; b) make authorized investments; pay necessary and reasonable administrative expenses; satisfy specified obligations under the Statute; make remittances to State to pay claims; purchase reinsurance and prepare for mitigation of effects of catastrophic natural events.

Statute provides for payment of operating expenses and losses. Association shall pay losses in excess of premiums from available reserves and available amounts in Fund.

Any excess losses beyond this shall be paid from proceeds of public securities or other financial instruments, the issuance of which is authorized by State legislature. A subchapter of Code authorizes issuance of such public securities and other instruments and specifies the circumstances in which they may be issued. Issuance of such instruments occurs after a request from Association to Commissioner. Bonds and similar instruments are issued by Authority and the Statute specifies how such Bond proceeds are to be used to deal with claims arising from a series of occurrences in the Catastrophe Area.

Bond proceeds will be deposited in a specified financial institution where they are held in trust for the exclusive use and benefit of Association. State law limits the purposes the Bond proceeds may be used for to include payment of claims, Association's operating expenses; purchase of reinsurance; payment of costs of issuing Bonds, providing a public security reserve; and pay capitalized interest and principal on the Bonds for period determined necessary. Additionally, excess Bond proceeds may be used to purchase or redeem Bonds. If no outstanding obligations or Bond administrative expenses, the proceeds shall be transferred to Fund. Statute provides the sources and manner of payments of principal and interest on different classes of bonds that are issued, which include assessments on member insurance companies and premium surcharge on policyholders

In the event of Association's termination, its net assets after satisfying outstanding liabilities would be transferred to the general fund of the Treasury of State.

Any person aggrieved by an act, ruling or decision of Association has a right to appeal directly to the Commissioner. Association must file monthly and annual reports to Commissioner. Association is required to comply with State open meeting laws and post notices of its board meetings in compliance with these laws. Statute provides that Association's Board of Directors is responsible and accountable to the Commissioner.

Analysis

Section 115(1) of the Code provides that gross income does not include income derived from any public utility or the exercise of any essential government function and accruing to a state or any political subdivision thereof.

In Rev. Rul. 77-261, 1977-2 C.B. 45, income from an investment fund, established under a written declaration of trust by a state, for the temporary investment of cash balances of the state and its participating political subdivisions, was excludable from gross income for federal income tax purposes under section 115(1). The ruling indicated that the statutory exclusion was intended to extend not to the income of a state or municipality resulting from its own participation in activities, but rather to the income of a corporation or other entity engaged in the operation of a public utility or the performance of some governmental function that accrued to either a state or municipality. The ruling

points out that it may be assumed that Congress did not desire in any way to restrict a state's participation in enterprises that might be useful in carrying out projects that are desirable from the standpoint of a state government and which are within the ambit of a sovereign to properly conduct.

In Rev. Rul. 90-74, 1990-2 C.B. 34, the Service determined that the income of an organization formed, funded, and operated by political subdivisions to pool various risks (casualty, public liability, workers' compensation, and employees' health) is excludable from gross income under section 115 of the Code. In Rev. Rul. 90-74, private interests neither materially participate in the organization nor benefit more than incidentally from the organization.

By providing an adequate market for essential property insurance in Catastrophe Area of State, as well as providing programs to help prepare and mitigate damages, Association is helping maintain its communities and stimulate the economic growth and redevelopment of State by promoting the availability of affordable commercial and residential casualty insurance. This policy is reflected by the fact that all property insurers writing direct policies in State must belong to Association, as well as the control of Association's operations by the Commissioner to whom Association must regularly report and whose Board of Directors is appointed by the Commissioner. Furthermore, Association's net gains are either maintained as reserves or are contributed to Fund.

Upon dissolution; all remaining assets after the payment of debts and liabilities shall become the property of State, so Association's income accrues to State.

Furthermore, private interests do not materially participate in Association nor benefit more than incidentally. Accordingly, Association's income is excluded from gross income under section 115(1).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Sylvia F. Hunt
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(Tax Exempt & Government Entities)